CARRET
Asset Management

July 2021

Carret Credit Insight

Transitory?

Everything is transitory if your time horizon is long enough…
but that is not how we invest.

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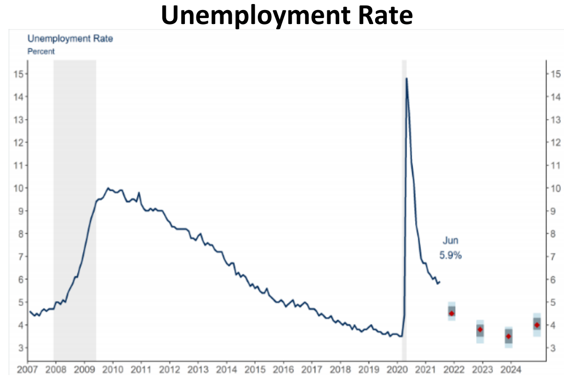
Firm AUM

$3.390 Billion

On December 11, 2020, the Food and Drug Administration (FDA) issued the first emergency use authorization for a vaccine to combat Covid. As 2020 was concluding, most estimates were that 80% of the population would be vaccinated by year-end 2021. The CDC website indicates that as of mid-July 2021, over 160 million Americans have been fully vaccinated - 48% of the population. It is estimated that by the time schools start in August, 50%+ of the population will be vaccinated and by year-end, 60%+ of the population will be vaccinated – a short fall from earlier estimates. Therein also lies the economic risk, as we anticipate that approximately 120 Million people will remain unvaccinated at year-end 2021. The unvaccinated will be heavily skewed towards the youth, which we expect will complicate the opening efforts of elementary and middle schools. While we would prefer to not have to focus on the virus and its variants, we do not have that luxury and thus continue to monitor the variants and Covid positivity rates.

Unemployment Rate



Source: Federal Reserve Bank of Richmond

While we recognize that risks remain, the vaccine is working and the economy is rebounding. Americans are shopping, traveling, and returning to the office. In turn, businesses are rushing to hire, with the hardest hit sectors (tourism and entertainment) leading the charge. Recall, the unemployment rate rose from 3.5% in January of 2020 to 14.8% (not including furloughs) in April of 2020 and has fallen back to 5.9% as of June of 2021… Imagine managing a business and having to lay off 18 Million people in 3 months and then having to hire back 14 Million people in the 13 months that followed. It's easy to understand why there is a shortage of input goods (e.g. computer chips, building materials) and supply bottlenecks.

Key Interest Rates	6.30.21	12.31.20	12.31.19
Prime Rate	3.25%	3.25%	4.75%
Fed Funds Rate	0.00% – 0.25%	0.00% – 0.25%	1.50% – 1.75%
3 Month U.S. T-Bill	0.05%	0.08%	1.55%
5 Yr U.S. Treasury Note	0.88%	0.36%	1.69%
10 Yr U.S. Treasury Bond	1.45%	0.92%	1.92%
10 Yr AAA Municipal Bond	1.01%	0.71%	1.44%
10 Yr A Corporate Bond	2.06%	1.62%	2.73%

Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

As the economy has rebounded, inflation has moved to levels not seen in recent memory:

- 1st Q Gross Domestic Product (GDP) hit +6.4% YoY and economists expect an increase of +9.1% YoY in the 2nd Q.
- The June Core Consumer Price index (CPI) was +4.5% YoY, the highest level since 2008.
- The May Core Personal Consumption Index (PCE) was +3.4% YoY, the highest reading since 1992.
- The June Core Producer Price Index (PPI) was +5.5% YoY, the highest reading since 2010.

With inflation running at recent record highs, it is surprising that the 10 Yr U.S. Treasury Bond is yielding only 1.30%. We have previously written that fair value for the 10 Yr Treasury has historically been 100 – 150 basis points above the rate of inflation – or materially higher than it is today. However, as inflation ramped up in the 2nd Q, the yield on the 10 Yr Treasury declined from 1.72% on March 31st to 1.30% in mid-July. How could this happen? Could it be that inflation is transitory?

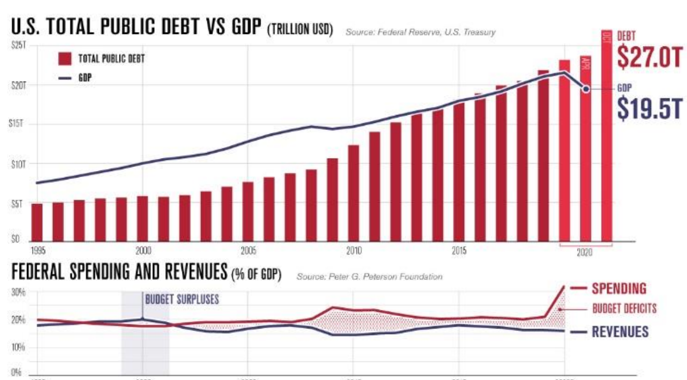
The FED has told us that it believes inflation will prove transitory, and thus, they remain more focused on reducing the rate of unemployment than combating this current bout of inflation. Federal Reserve Chair Jerome Powell recently acknowledged that inflation is rising faster than anticipated, but that he continues to believe it will prove transitory, saying, "we won't have to wait a tremendously long time, I don't think, to know whether our basic understanding of this is right." For now, investors are taking the FED at their word.

What if policy makers are wrong and inflation proves less transitory that expected? We have consistently written that sustainable, long-term inflation is driven by wage growth, which we are seeing today for various reasons – tight labor markets as a result of on-going government stimulus, older workers leaving the work force, and increasing minimum wages. We believe that it is difficult for wages to decrease once they increase. We also know that most families spend what they make, driving demand for goods higher. We therefore believe that in the short to intermediate term, the risk is for inflation to rise more than anticipated (albeit at modest levels) and therefore, rates should trend modestly higher.

This is the conundrum for investors – with the 10 Yr Treasury at 1.3%, we believe the risk of rates rising to 2.0% is greater than the reward of rates falling below 1.0%. Afterall, we believe the FED will move *SLOWLY* when they inevitably attempt to reduce monetary stimulus. Like all FED Chairmen, you have to ask… does Chairman Powell really want to be the person to slow this economy? We all know the answer, and thus believe the probability of the FED letting inflation run above trend for longer is the more likely scenario. Under this scenario, the interest rate trend is upward. Given our risk / reward focus on investing, we are positioned for a modest increase in rates.

We mentioned that we are surprised that rates are so low relative to the economic strength and inflation rates that we are currently experiencing. We view one of our core strengths as keeping our economic and market outlook focused on the coming 6 - 12 months – longer forecasts are typically of nominal value. However, we are starting to believe that the Government's reaction, both monetarily and fiscally, from the combination of the 2008/2009 financial crisis and Covid just may have broken the "system". It took 100 years for the US to accumulate $10 Trillion in debt and only another ten years to accumulate the next $10 Trillion. In 1994, the US budget deficit stood at $203 Billion (2.8% of GDP) and the national debt was $3.4 Trillion (47.8% of GDP). In 2020, the Congressional Budget Office (CBO) estimated that annual budget deficits will exceed $1 Trillion going forward and the national debt will more than double in the coming decade. These numbers do not account for the roughly $65 Trillion of unfunded liabilities for Social Security

U.S. Total Public Debt vs. GDP



Source: Federal Reserve, U.S. Treasury, Peter G. Peterson Foundation and Medicare. Today, the US has about $27 Trillion in debt and growing daily with no “plan” to slow it. If rates rise by 1%, that is $270 billion of additional annual interest expense. Given the debt load, any increase in rates will act as a natural drag on the economy. The FED has run out of ammunition to effectively smooth out business cycles. This is a global challenge and the reason why rates are negative in Europe and Japan. We hope we are wrong, but have growing conviction that economic growth and thus inflation in the decades ahead will be muted. So, while we believe the short to intermediate trend is toward higher rates, we are starting to believe that longer term, rates will remain at low levels. Going forward, fixed-income investors will need to be nimble and opportunistic to add value.

As always, we believe it is important to monitor the FED’s economic projections. The following is the **FED’s Summary of Economic Projections** released on June 16th: The FED projections reflect a strong economic outlook. The FED expects the economy (GDP) to expand by 7.0% in 2021, 3.3% in 2022 and 2.4% in 2023. The longer run projected growth rate remains at a more normalized 1.8%. The FED expects the labor market to recover quickly with the unemployment rate projected to end 2021 at 4.5%. The unemployment rate is now expected to end 2022 at 3.8% and 2023 at 3.5%. Inflation, as measure by Core PCE, is expected to be above the FED’s 2.0% target through 2022. The FED expects the Core PCE index to be 3.4% for 2021, but slow to 2.1% for 2022. The DOT Plot shows the majority of participants expect the target rate to remain at zero through the end of 2022, with two hikes in 2023. The FED expects the economic rebound to be robust with unemployment falling materially and inflation moving higher; however, they expect 2022 to be a more “normal” year in terms of economic growth and inflation.

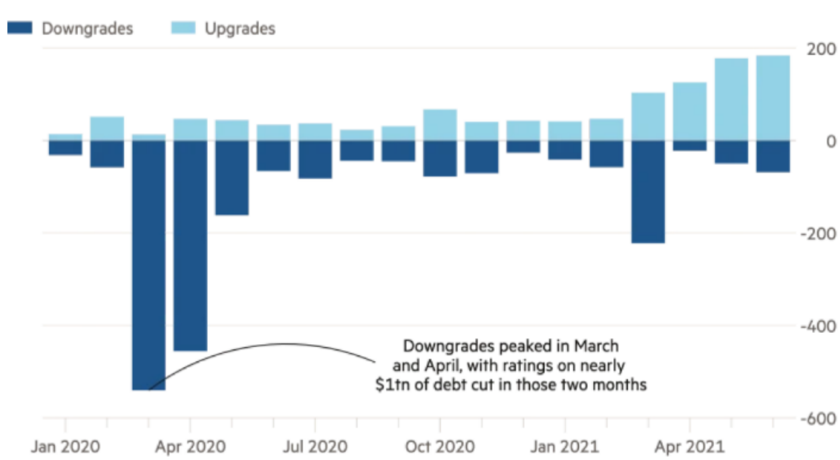
Taxable Bond Strategy

For corporate bonds, inflation has been the prominent story so far in 2021. The effect inflation – and the subsequent realization that it might prove “transitory” – had on Treasury rates was reflected in the corporate bond market. Corporate yields rose and fell along with Treasuries, albiet to a lesser degree as spreads tightened in the first half of the year. Throughout the volatility, corporate bonds were bouyed by strong demand – investors have favored corporate bonds because the absolute yield offered is signifcant relative to historically low Treasury yields.

Inflation has a dual effect on corporate bond issuers. The first effect is that it typically raises borrowing costs – i.e. yields. The second effect is that it can raise input costs – think materials and labor. In today’s environment, companies are in an intense competition to hire workers which leads to higher labor costs – a negative from the business perspective. Toss in the supply bottlenecks around the world pushing up material costs and businesses today are getting hit with a “double whammy”. The positive point of view for businesses is that they have pricing power. Althought the inputs are becoming more expensive, companies can maintin profit margins by raising the price they charge for their products and services. The strong demand for goods and services (everything from home improvement supplies to dinner at your favorite restaurant) allows for these price increases. The savings rate for the average American is at record levels – a nod to government Covid stimulus programs. Americans seem eager to spend and businesses are ready to reap the rewards.

Rating agencies have a rosier outlook for Corporate America

Value of U.S. corporate debt upgraded or downgraded each month ($bn)



Source: Bank of America, FT

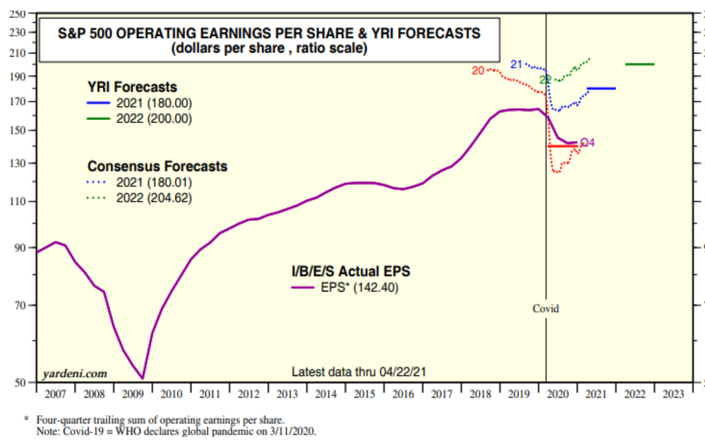
Our Taxable Fixed Income Strategy continues to be overweight corporate bonds relative to the index (86% vs. 37%). This allocation reflects our bias towards taking on incremental credit risk while minimizing interest rate risk. We are confident in our credit risk bias with GDP growth strengthening and corporate America continung to report solid revenue and earnings growth. Credit rating action on corporate bonds supports our conviction.

Carret Credit Insight

During the second quarter of 2021, rating upgrades have outpaced downgrades. This is a major reversal from early 2020 when nearly $1 trillion of corporate debt was downgraded with the onset of Covid lockdowns. Another influential event that began in March 2020 was the FED's purchasing of corporate bonds – a first in history. The total value of bonds bought ($13+ billion in individual bonds and ETFs) did not amount to much; nevertheless, the program had a big impact in *signaling* to the market that the FED would supply liquidity if necessary. The FED has announced it is winding down the program and selling the holdings by year-end. Despite this, we are comfortable that the FED will step in during future crises to backstop the corporate bond market. On the interest rate front, yield curves remain stubbornly flat – we believe there is minimal value added by extending along the curve. As we have stated time and again, we are comfortable taking risk if we are getting paid to do so.

We have written previously about the deluge of corporate bond issuance during 2020. Recall that companies took advantage of falling interest rates and investors' insatiable demand. The flood of new issuance in 2020 saw the pendulum swing in the opposite direction to begin 2021. Year to date through the end of June, corporate bond issuance is down 21.4% versus the prior year with investment grade (IG) issuance down 32.7%. While this swing is significant, it is not an over-correction. Total corporate debt outstanding remains at record levels and issuance is back in line with its pre-Covid trend.

Barclays US Corp High Yield Index vs. 5 Yr US Treasury



Source: I/B/E/S data by Refinitiv

As of June 30th, our overweight corporate bond allocation focuses on A and BBB credits. During the first half of 2021, 5 Yr A rated corporate yields rose 34 bp (0.84% to 1.18%) and 5 Yr BBB yields rose 23 bp (1.31% to 1.54%). Relative to 5 Yr Treasury, corporate spreads tightened over the past six months with A rated spreads falling from +48 bp to +30 bp and BBB rated spreads moving from +95 bp to +66 bp. Corporate spreads have continued to tighten since before the Covid pandemic gripped the world. The 2 to 10 Yr Treasury spread widened over the first half of the year, ending June 30th at +120 bp. The widening resulted from a move higher in the long end of the curve as inflation worries penetrated the market during the 1st quarter. Expectations for the inflation to be transitory in nature brought the spread *down* to +120 from the end of the 1st quarter level of +158.

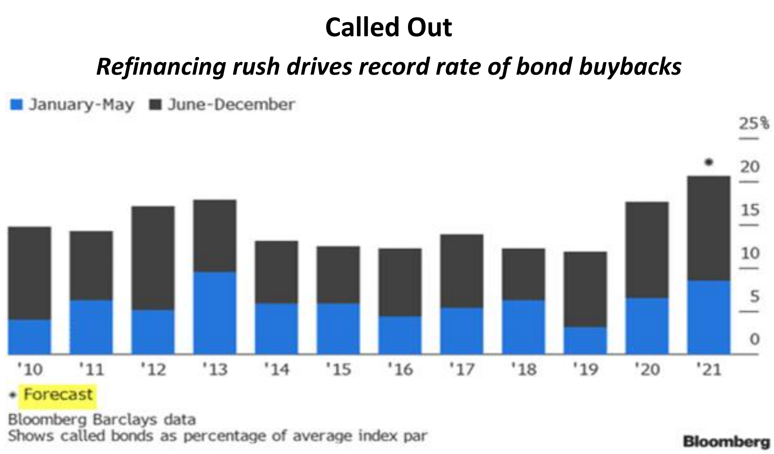
The ***Taxable Bond Strategy*** is focused on high-quality IG, intermediate-maturity bonds. As of June 30th, portfolios were structured to target an average yield to maturity (YTM) of 1.30% with a duration of 3.3, and an average credit rating of BBB+ relative to a benchmark yielding 0.92%. We continue to be overweight corporate bonds relative to our benchmark as yields of Treasury and Government Agencies remain low. We find corporate bonds attractive despite spreads tightening over the past six months. Our allocation to preferred securities increases the overall yield and captures incremental cash flows, while enhancing the level of diversity within the strategy. With the FED signaling continued support of short duration bond markets, tightening credit spreads, and rising inflation, we feel warranted in holding a current duration target of 3.0-3.5 Yrs. We are maintaining our flexibility to reinvest maturities and cash flows into a potentially upward moving interest rate environment.

Opportunity Strategies

We continue to find value in short duration, high quality, high yield (HY) bonds. At mid-year, the iBoxx HY Index yielded 3.95%. Throughout the first half of 2021, HY and lower quality (BBB) IG credit spreads tightened as the economy and corporate profits rebounded, the perceived FED backstop remained in place, and investors sought safety and income. Bond funds' 2021 inflows are on track to surpass 2019 and 2020 levels, reaching $372 billion as of June

23rd, according to the Investment Company Institute. Flows into the corporate bond market have made up the lion's share of bond inflows.

As we have said before, "this isn't your father's junk bond market". Almost 55% of bonds in the ICE BofA US HY index carry an average credit rating of BB, which is up from 47% in 2019 before the Covid pandemic, and 38% in 2008 before the financial crisis. Thus, an increasing portion of HY indexes are weighted to bonds that are safer than they were in prior periods. This change suggests that HY volatility will be lower than before and could "pull" more investors into this market – creating value for current investors. Corporate titans such as Ford, Delta Airlines, Dell Computer, Netflix, Sprint/T-Mobile, and United Airlines are all HY rated and are core positions in portfolios.



Source: Bloomberg

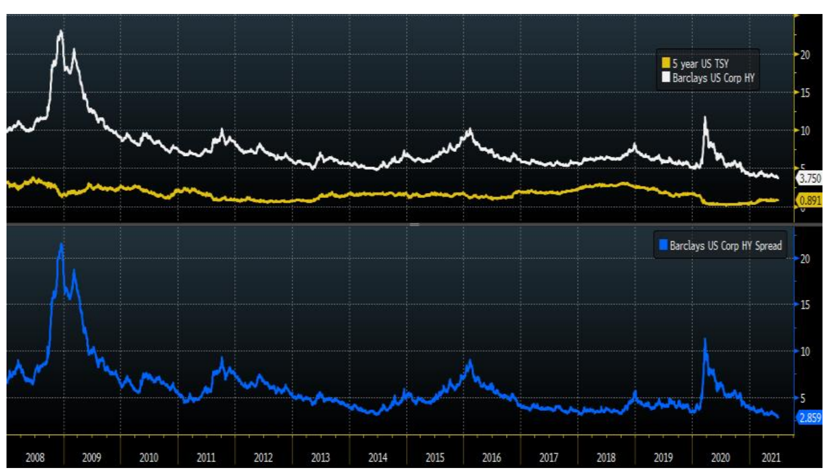
During the first half of 2021, we were rewarded for investing in high coupon corporate bonds as several of our core holdings experienced calls and tenders. Tenders benefit performance as the companies of the debt we owned had to pay us above market values to buy their bonds back from us. Tender and call activity have been running at multi-year highs. We anticipate this trend will continue into the second half of the year, albeit at a slower pace. We remain challenged to identify investment opportunities in preferred securities and busted convertibles at our target prices.

HY spreads – the yield differential between Treasuries and HY bond yields – tightened by 80 bp during the first half of the year, while rates on 5 Yr Treasury bonds increased by 52 bp. Spreads, as of June 30th, contracted to +307 bp compared to +387 bp at the beginning of the year. Spreads are 273 basis points tighter than the +580 25 Yr historical average spread. While we anticipate a positive fundamental environment for credit investors – mainly driven by strong corporate profits – we remain focused on the following risks: historically tight valuations coupled with event risk and equity value creation vs. balance sheet deleveraging.

As of June 30th, 27% of our Opportunity Strategy was invested in IG bonds while the Leveraged Opportunity Strategy had 16% invested in IG bonds. With spreads at record lows and a "flat-ish" yield curve, we are defensively positioned, from both a duration and credit perspective, and are patiently awaiting a return of volatility. We remain anxious to redeploy capital to a higher risk profile, but as we always say… "We like to take risk, but only when we get paid to do so". We are not currently getting paid to do so. As mentioned, we are finding solid relative value in the short duration / higher quality HY part of the market.

At mid-year, our ***Opportunity Strategy***, on average, had a YTM of 2.27%, a duration of 2.2, and an average credit rating of BB. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 2.64%, a duration of 2.0, and an average credit rating of BB-. Given our defensive positioning, The Leveraged Opportunity strategy remains unlevered.

Barclays US Corp HY Index vs. 5 Yr US Treasury



Source: Bloomberg

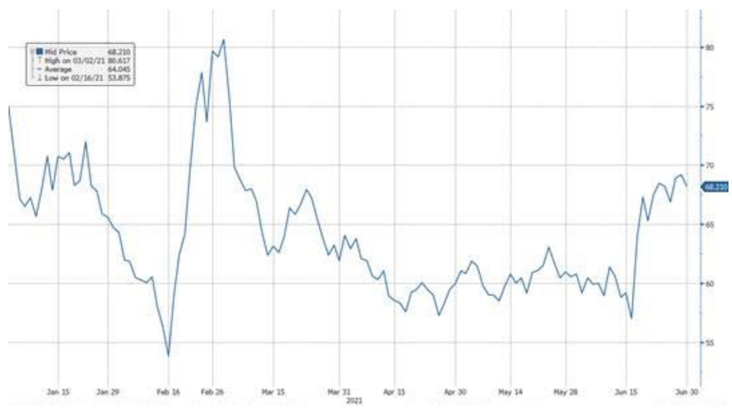
Municipal Bond Strategy

The municipal bond market found surprising stability in the first half of 2021 despite the somewhat confusing mixed bag of data points. In general, municipal bond yields were driven by a balanced supply and demand dynamic alongside favorable credit fundamentals. As we review the first half of 2021 and model ahead, it is hard to overstate the importance of the American Rescue Plan for the municipal marketplace. Federal funds should continue to flow to municipalities, schools, and transportation facilities (just to name a few segments). These funds, along with the reopening of the economy and revenue recovery, have certainly created a sound base for municipal credits and issuers.

Despite the mixed headlines and the economic cross-currents, the interest rate environment, for high-quality municipal bonds, has been fairly benign for the first half of 2021. AAA Muni yields rose in the first quarter and then held mostly unchanged in the second quarter resulting in a slight rise in yields year to date. Representative first quarter yields increased +28 bps, +36 bps, and +39 bps for 5, 7, and 10 Yr bonds respectively. We expect that stable economic growth, favorable supply and demand dynamics, and easing credit risks should help maintain today's positive market trend.

During the first half of the year, Municipal-to-Treasury (MOT) ratios were fairly volatile as 10 Yr US Treasury yields marched to 1.75% in March before starting the gradual decline to sub-1.50% as of June 30th. Municipal bond yields moved in sympathy with Treasuries, but not basis point for basis point. The result was a choppy ratio trend with a peak of 81% in March before closing out June at 68%. The 100-day and 200-day moving averages (for the 10 Yr MOT ratio) were 61.5% and 78% respectively. These ratio levels coincide with relative outperformance, driven by these technical factors.

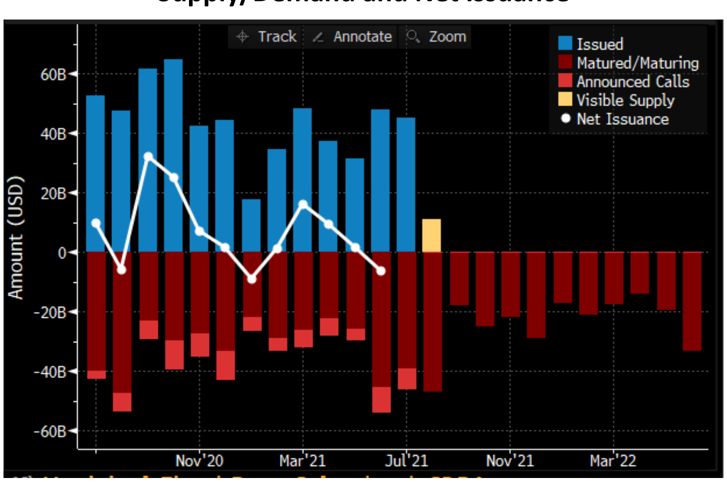
Muni-to-Treasury 1H21



Source: Bloomberg

Over the past few weeks, the likelihood has increased that an infrastructure spending package and accompanying tax reforms should pass through Congress. Last month, a bipartisan group of senators reached an agreement with the Biden administration to provide $600 billion of new funding for traditional, physical infrastructure projects. Many plan details have yet to be defined, including several possible measures that could positively impact the municipal bond market. Higher tax rates support demand for tax-exempt municipal issuance while other expected policy changes may end up increasing taxable supply. We are watching other measures that can certainly impact the municipal landscape. These include renewed support for restoring tax-exempt advance refundings (Pre Re's) and a potential "roll back" of current state and local tax (SALT) deduction caps.

Supply/Demand and Net Issuance



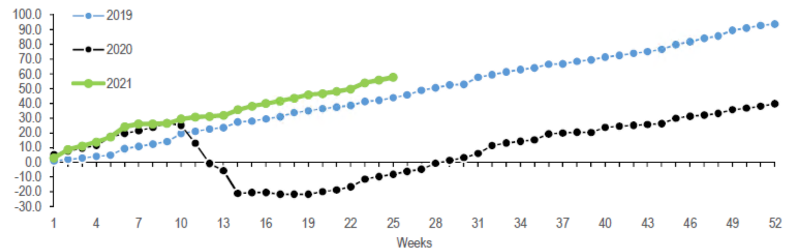
Source: Bloomberg

Municipal new issuance sits at $224 billion at mid-year 2021. This is up 7% over last year, when the second quarter 2020 had light issuance in the early days of the Covid pandemic, followed by a sharp increase over the summer of 2020. As we look deeper at the data, tax-exempt issuance currently represents 75% of total issuance while taxable issuance fills in the remaining 25%. New project financing outpaced refinancing by a margin of 3-to-1 in the first half, which is a good sign for the municipal bond landscape. For the remainder of

2021, we expect new issue supply to come in slightly ahead of the first half pace. This would put the market just behind last year's level, but still ahead of the 5 and 10 Yr average issuance amounts. Taxable municipal supply has been lighter in 2021. However, this may change in the quarters and years ahead as part of the infrastructure financing plan.

From the demand-side, investors have been pouring new money into Mutual Funds and Separately Managed Accounts (SMAs) in 2021. Using Mutual Funds as the proxy for demand, net inflows have averaged more than $1.9 billion each week this year, according to Refinitiv/Lipper Data. Monthly Fund flows recorded $9 billion, $6 billion, and $9 billion in April, May, and June, respectively. The prospects for higher taxes (down the road) have heightened the demand for municipal bonds. With a broader view, there have been positive net inflows for 53 out of the last 57 weeks for Municipal Funds and SMAs. In the second half of 2021, we expect a solid demand to continue as a surge of cash is expected to hit the municipal-bond market from bond calls and maturities. Investors are set to receive nearly $60 billion of principal and interest payments in August, the biggest such payout of the year.

Cumulative Municipal Bond Fund Flows (YoY)



Source: Rifinitive Lipper

Our high-quality, intermediate-maturity bias continues to seek a balance of preservation of principal, total return, and tax-exempt cash flows. We will continue to opportunistically add value through credit research, bond structure, and yield curve positioning. Our municipal bond portfolios are actively managed as either state-specific or state-focused (general market in approach, otherwise). Essential service revenue bonds and high-quality general obligation bonds continue to make up the framework of our municipal bond portfolio strategy. We continue to be cautiously optimistic in our expectations for the municipal marketplace for the remainder of 2021. Our Municipal Bond Strategy is focused on high-quality IG, intermediate-maturity bonds. Portfolios are currently structured to target an average YTM of 1.52% and a YTC of 0.68%. These metrics equate to a Taxable Equivalent Yield (TEY) of 2.94%* and 1.32%* respectively. Our strategy duration-to-maturity is 5.4 years our duration-to-call is 3.9 years. The average credit rating is AA-.

** Assumes 48.3% Combined Effective Tax Bracket*

Separately Managed Account Strategies:

Municipal: Carret's Municipal Bond Strategy seeks to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment-grade portfolios with a diversified blend of issuers, sectors, and maturities aimed at delivering consistent, risk-adjusted returns with an emphasis on tax-efficient cash flows.

Taxable: Carret's Taxable Bond Strategy seeks to achieve above average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment-grade fixed income securities and shift across bond sectors based on changing market conditions. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk-adjusted returns.

Opportunity: Carret's Fixed Income Opportunity Strategy seeks to generate a high level of current income with a secondary focus on long term capital appreciation. We utilize higher yielding fixed income securities and shift among various types of fixed income securities based on changing market conditions. We actively manage risk and reward and can respond quickly to market movements. We utilize interest rate hedges to limit duration risk.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy seeks to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Enhanced Cash: Carret's Enhanced Cash Strategy seeks to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short duration investment-grade bonds. Our custom approach opportunistically utilizes tax-advantaged municipal bonds to enhance overall after-tax returns when appropriate.

Mutual Fund Strategy:

Kansas Tax-Exempt: The Carret Kansas Tax-Exempt Bond Fund's objective is to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.